Over the past few years, concerns about the compensation expense and share dilution of equity compensation programs have caused many employers to reduce the number of employees who are eligible for stock option grants and restricted stock. Yet, as the economy improves and the labor market grows increasingly competitive, some employers are gaining a renewed appreciation for employee stock purchase plans (ESPPs) as an expense efficient, broad based equity compensation program.

ESPPs can provide an effective way to incentivize employees, foster a culture of employee ownership and accountability, and deliver benefits similar to those of other forms of equity compensation, but generally at a much lower cost and share usage.

Employees value ESPPs too, as these plans enable employees to help boost their overall compensation and participate in their company’s success by using after-tax income to acquire company stock, often at a discount. Depending on the type of plan, most of the gain on the stock is taxed as a capital gain rather than as ordinary income, assuming shares are held long enough.

In this paper, we trace the evolution of ESPPs and the potential benefits they offer to both employees and employers. We examine plan design considerations and their effect on employee participation rates. We also provide case studies that illustrate how some Fidelity Stock Plan Services clients are taking different approaches to ESPP plan design and participant communications.

KEY TAKEAWAYS

- Despite the challenges imposed by FAS 123R, which became ASC 718, ESPPs are still an important component of many equity compensation plans.
- ESPPs can help promote an ownership mentality across a broad base of employees at a relatively low cost.
- Plan design changes, particularly those related to discount rates and look-back periods, often have a big impact on participation rates.
ESPPs Continue to Thrive

Not too long ago, many equity compensation professionals were viewing ESPPs as a somewhat old-fashioned and underutilized component of their overall equity compensation plans. The adoption of FAS 123R (now ASC 718) in 2005 contributed to a perception that ESPPs might fade from the equity compensation landscape, similar to the way traditional pension plans have declined.

This perception was primarily due to the ASC 718 mandate that ESPPs with “option-like” features be treated as a compensation expense on a company’s income statement. Due to this change, companies that offered Section 423 plans with a discount or a look-back period incurred increased compensation expenses. Today, only “safe-harbor” plans that provide no more than a 5% discount from fair market value (FMV) and no look-back avoid compensation expenses.

Compensation committees have also come under pressure in recent years to reexamine their equity compensation practices, with a particular emphasis on expenses and share usage. In this environment, some employers modified their ESPPs to minimize expense by reducing the benefits offered. With the lower value delivered by these plans, participation rates declined, resulting in lower share usage. This decline in participation rates reflects the decline in employee satisfaction with the plans.

Despite the challenges posed by ASC 718, recent survey results and industry data show that, to paraphrase Mark Twain, “News of the death of ESPPs has been greatly exaggerated.” In fact, many employers continue to offer ESPPs because these plans enable employers to offer equity compensation benefits to a broad-based employee population at a relatively modest compensation cost. Employees, especially those who are ineligible for stock options or restricted stock grants, appreciate ESPPs because in many cases they provide a guaranteed rate of return (5% to 15%) that far exceeds what they can earn in today’s ultra-low interest rate environment. As a result, some employers who previously eliminated or downgraded their ESPPs are revisiting their benefit plans and exploring the possibility of either relaunching an ESPP or modifying their existing ESPPs to make them more attractive to employees.

As the economy continues to improve, companies are reinstating their discount as they realize that an attractive ESPP can be a significant asset in attracting and retaining the most talented employees—especially in competitive hiring markets like technology, professional services, and transportation.

The benefits of an ESPP aren’t just limited to the employee. Employers get a big bang for their small ESPP buck. According to a 2012 survey of 1,800 Fidelity Stock Plan Services participants, recipients of all forms of equity compensation report that their stock plans make them more loyal and more motivated to work hard. In fact, Fidelity’s survey revealed that ESPP-only participants (those with no stock option or restricted stock grants) were more satisfied with their equity compensation plans than participants who also received stock options or restricted stock. In addition, ESPP-only participants were highly engaged, with more than 80% aware of the current company stock price and more than 70% actively checking their stock purchases.

In today’s environment, many employers are revisiting their plan designs and making changes that enhance their financial benefits and—by extension—their appeal to employees. Even newly public companies are recognizing that ESPPs can help them compete more successfully for talent. According to the “2013 IPO Executive Compensation Study” from Connell & Partners, 40% of newly public companies implemented an ESPP upon going public. These plans offered an average look-back of six months and a 15% discount, making these plans attractive to a broad-based employee population. About 50% of companies implemented an evergreen feature, providing for an automatic, annual replenishment of shares, with a median replenishment of 1% of shares outstanding added to the plan every year.
Plan Design Considerations

Plan sponsors who are looking to increase participation rates for an existing ESPP or who are thinking about initiating an ESPP for the first time may want to consider the following important plan design “levers” when designing an ESPP:

Qualified or Nonqualified?

Most employers have chosen to offer plans that meet the requirements of Section 423 of the Internal Revenue Code (“qualified plans”). In fact, according to the NASPP and Deloitte 2011 Domestic Stock Plan Administration Survey, 82% of survey respondents reported that their ESPP was qualified under Section 423. Among ESPPs managed by Fidelity Stock Plan Services, 86% are Section 423 qualified. This trend has been gaining momentum, with significantly more Fidelity administered plans moving from nonqualified to qualified status over the past seven years.

The tax benefits of a qualified plan are clear for U.S. employees. Yet, qualified plans do have limitations and requirements, set forth in Section 423 of the Internal Revenue Code:

- Only employees of the company (or its parent or subsidiary corporations) may participate in the plan.
- The purchase plan must be approved by the shareholders of the company within the 12 months before it is adopted by the board.
- Any employee owning more than 5% of the company stock may not participate in the plan.
- All eligible employees must be allowed to participate in the plan, although certain categories of employees may be excluded (e.g., employees who have been employed less than two years).
- All employees must enjoy the same rights and privileges under the plan, except that the amount of stock that can be purchased may be based on compensation differences.
- The purchase price may not be less than the lesser of 85% of the fair market value of the stock at the beginning of the offering period or on the purchase date, whichever is lower.
- The maximum offering period cannot exceed 27 months unless the purchase price is based solely on the fair market value at time of purchase, in which case the offering period may be as long as five years.
- An employee may not purchase more than $25,000 worth of stock (based on fair market value on the first day of the offering period) for each calendar year in which the offering period is in effect. Where the offering period extends over more than one calendar year, the limit is $25,000 worth of stock for each calendar year in which the offering period is in effect.
Discount Rate

For employees, perhaps the most important feature of an ESPP is that it allows them to purchase company stock at a discount to its current fair market value. Under Section 423, employers can provide discounts of up to 15% from the stock’s fair market value. However, discounts of greater than 5% are subject to compensation expenses.

Employers who are seeking to promote high ESPP participation rates should consider the potential beneficial impact of a higher discount rate, despite the higher compensation expense.

For U.S. participants, no tax is due on the purchase of discounted shares. For shares that are sold in a “qualifying disposition” (those held at least two years from the date of the grant and one year from the date of purchase), the lesser of the actual gain on the sale or 15% of the “begin date” fair market value is the only component that is taxed as ordinary income. All additional gains are taxed as long-term capital gains. If shares are sold earlier, than the two-year and one-year periods described above, the sale is classified as a “disqualifying distribution” and the spread at purchase is taxed at ordinary income tax rates. Any additional gain is taxed as a capital gain (or loss).

After FAS 123R (now ASC 718) took effect in 2005, many companies reduced the ESPP discount to 5% at the date of purchase to avoid compensation expenses. After making this change, some employers soon discovered that a lower discount rate had a significant negative effect on employee perceptions of the value of their ESPP and on their participation rates.

Look-Back Period

The look-back feature allows employees to purchase company stock based on either the FMV on the first day or the last day of the purchase period, whichever is more beneficial (i.e., lower). When combined with a discount, this feature can enhance the value of ESPP shares significantly. A look-back provides value for plans where the stock price appreciates. Where stock prices are stable or declining, the look-back offers limited value.

The Deloitte 2011 Domestic Stock Plan Administration Survey, presented by the NASPP and Deloitte Consulting, shows that among those companies that offer a Section 423 plan, 62% offered a look-back. The most common look-back period was six months (61%), followed by 24 months (14%). As with the discount rate, employers need to find the right balance between including features that will increase employee participation and the compensation cost of those features.

To understand how the combination of a look-back and a 15% discount can benefit employees, consider a company with a FMV of $10 at the beginning of the period, a look-back, and a 15% discount. If the stock price at the end of the period is $13, employees purchase shares at $8.50 ($10 x 85%). If the stock price falls to $9 at the time of purchase, the employee purchases shares at $7.65 ($9 x 85%). While look-backs and discounts will increase the compensation cost of the plan, they are also the primary drivers in delivering more value to employees.

Apple’s ESPP is a great (though extreme) example of the power of a discount and a look-back. For the period between October 1, 2004, and March 31, 2012, employees who participated enjoyed a total return of 869%.*

More than half of companies surveyed recently intend to upgrade their ESPP over the next two to three years, with nearly one-third introducing or increasing the discount or adding a look-back.

Source: Richard Day Research/Market Probe.

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**“$1.6 Million for Apple Employees, Up $500,000 in Six Months,” Forbes.com, March 14, 2012.
Offering Period

The period during which employees can contribute to their plan through after-tax salary deductions is known as the “offering period.” Offering periods typically range from three months to 24 months. ESPPs with longer offering periods tend to be more challenging to administer, more expensive, and more dilutive. Generally, the longer the offering period, the more shares used.

The interval during the offering period when contributions accumulate toward a stock purchase is commonly called the “purchase period.” An offering period may include a single purchase period or multiple purchase periods. Plans that feature longer offering periods often include multiple purchase periods. Generally, longer offering periods are more attractive to employees than shorter periods when the plan includes a look-back, and even more so if the plan includes multiple purchase periods within a single offering period.

Employers who are looking to manage compensation expenses and administrative complexity may want to consider reducing the length of their offering period, as participants are likely to respond more favorably to this type of change than to a reduction in the discount rate or the elimination of the look-back.

Contribution Changes, Resets, and Rollovers

Design features that provide employees with additional flexibility may help improve participation rates, but they can also increase the compensation cost and increase administrative complexity.

With regard to contribution changes, consider the length of the offering period. While it may be reasonable for employees to contribute a fixed amount for a one- or three-month period, this may not apply over longer periods. Being too restrictive for long periods can drive participation rates lower. If the plan does not permit employees to change their contribution rate, that may discourage them from participating in the first place. A compromise solution might be to allow participants to change their contribution rate once during each period. This approach balances administrative ease with participant flexibility. Where there are multiple purchases in a single offering period, it is common to also allow contribution changes before each new purchase period.

Flexibility is important in situations where the plan provides for a “look back” and also for multiple purchases within the offering period, and the fair market value on the purchase date is less than the fair market value on the begin date. In these situations, a “reset” option is attractive to participants. The reset feature provides that any look-back be based on either the fair market value as of the beginning of the purchase period immediately following the date when the reset is triggered (typically one day after) or the fair market value on the purchase date. This allows employees to use the lower price for the remainder of the offering period, thus achieving the lowest possible purchase price.

Similarly, a “rollover” feature can benefit employees when the stock price on an exercise date is lower than the price on the grant date. With a rollover, the offering period is canceled immediately after the purchase date and employees are “rolled over” into a new offering period that uses the lower stock price as the base price. Note that the reset and rollover features only apply to plans that have multiple purchase periods within a single offering period, such as a 12-month offering with two six-month purchase periods.
**Contribution Limits**

The number of shares purchased within an ESPP is dependent on the number of employees who participate, how much they contribute, and the price paid for the stock. Due to variations in these factors, employers may have difficulty predicting how many shares will be purchased during a particular offering period, as well as the compensation expense (if applicable).

Determining the number of shares purchased becomes more challenging when a company’s stock price is volatile. On the one hand, employees may purchase a higher number of shares when the company's stock price is declining. On the other hand, a rapidly rising stock price may also encourage more employees to participate in the ESPP, which also causes the number of shares purchased to increase.

Section 423 plans limit the amount of company stock that employees can purchase during each calendar year to a value of $25,000 based on the FMV at the time of grant. Additionally, in order to establish the grant date as the beginning of the offering, the plan must establish a maximum limit on the number of shares that can be issued to each employee during the offering. This share limit can be a fixed share amount or can be based on a formula; the $25,000 limit is not sufficient for these purposes. Employers sometimes take this a step further by implementing a more restrictive limit on the total number of shares employees can buy during each purchase period to manage the share usage.

If an employee bumps up against any of these limits, the plan refunds the excess contributions, but often with zero interest paid. To prevent that from happening, employers should establish processes to suspend payroll deductions when employees hit a limit.

**Plan Before You Act**

Despite the obvious benefits that ESPPs can provide to employees, participation rates at many companies remain relatively low. According to the Deloitte 2011 Domestic Stock Plan Administration Survey, only 25% of respondents with a qualified ESPP had participation rates above 50%. More than half reported participation rates of 30% or lower.

These results indicate that many employees simply are not grasping the value of their ESPP benefits. This may require employers to adopt a renewed focus on participant communications to help improve participation rates. Whether plan sponsors are launching a new ESPP or trying to increase participation in an established plan, the quality, quantity, and timing of participant communications will play a critical role in participation rates.

While this paper examines several important considerations that will have an impact on ESPP participation rates and plan expenses, it’s important to note that each employer’s unique goals and challenges will affect its plan design. Before making any changes, plan administrators should consider the following questions:

- What role does the ESPP play in the company’s overall equity compensation structure?
- Would changes to the ESPP plan design likely increase or decrease employee participation?
- What impact would plan design changes have on the company’s compensation expenses?
- How will changes be communicated to participants?
- What impact will any ESPP changes have on employee satisfaction?

**Learn More**

Fidelity Stock Plan Services can help you get the most out of your ESPP. To learn more, call 800.468.5521 or contact your Fidelity Stock Plan Services Representative.
### Does Your ESPP Need a Touch-Up or an Extreme Makeover?

The table below shows the potential impact that small adjustments or larger changes may have on your ESPP’s participation rates and compensation expense.

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Just a Touch-Up</th>
<th>Make Me Shine</th>
<th>A Whole New Look</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>5% discount, no look-back, 6-month offering period</td>
<td>Reduce offering period to 3 months</td>
<td>Raise discount to 10% or 15%</td>
<td>Raise discount to 15%, introduce look-back, reduce offering period to 3 months</td>
<td>o With no look-back, longer offerings don’t add value. Shorter offering periods encourage participation and do not add to compensatory expense.</td>
</tr>
<tr>
<td>Potential impact on participation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Potential impact on expense</td>
<td>No change</td>
<td>Some incremental expense</td>
<td>More incremental expense due to look-back (minimized with shorter offering)</td>
<td></td>
</tr>
<tr>
<td>10% discount, no look-back, 6-month offering period</td>
<td>Reduce offering period to 3 months</td>
<td>Reduce offering period to 3 months and add look-back</td>
<td>Reduce to a 3-month offering period, add look-back, and increase discount to 15%</td>
<td>o Employees easily understand and value a discount. Any increase in discount is likely to increase participation. Increases to discount will increase compensation expense.</td>
</tr>
<tr>
<td>Potential impact on participation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Potential impact on expense</td>
<td>Slight decrease in expense</td>
<td>Some incremental expense</td>
<td>More incremental expense due to look-back and increased discount (minimized with shorter offering)</td>
<td></td>
</tr>
<tr>
<td>15% discount, no look-back, 3-month offering period</td>
<td>Add a look back</td>
<td>Extend offering period to 6 months and add a look-back</td>
<td>Extend offering period to 12 months (with two 6-month purchase periods with a look-back)</td>
<td>o Compensation expense isn’t just related to the discount. Offering period length and look-back also impact expense. Incremental compensation expenses can be managed by decreasing other plan design elements.</td>
</tr>
<tr>
<td>Potential impact on participation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Potential impact on expense</td>
<td>Some incremental expense</td>
<td>More incremental expense</td>
<td>More incremental expense due to look-back and increased discount</td>
<td></td>
</tr>
</tbody>
</table>
Case Study

Hologic Increases ESPP Participation Rate through Enhanced Plan Design and Communications

Hologic is a supplier of diagnostic products, medical imaging systems, and surgical products geared toward solving women’s health issues. The company’s senior management team believes that investment in and commitment to employees is the key to achieving the company’s mission.

Recognizing that in order to be the best, the company needs to attract the best people, Hologic offers programs and practices to create a strong talent pipeline for future growth, including a newly enhanced ESPP that was introduced in 2012. The new and improved ESPP features a 15% discount and six-month look-back, replacing the previous safe harbor plan that offered a 5% discount and no look-back.

Employees at Hologic wasted little time taking advantage of the ESPP enhancements. In fact, during the six weeks after Hologic announced the increased employee discount and look-back, enrollment shot up from 14% to 31%.

“We had a little over 300 participants in the stock purchase plan, but after we made these revisions we had over 900 by the end of the first enrollment period,” said David Peterson, Director of Global Compensation and Stock Administration at Hologic. “The vast majority of our employee population was very appreciative and happy about the increased discount and new look-back.”

The increased participation rates didn’t end with the initial bump. As more employees learned about the improved plan design, participation rate continued trending up, hitting 44% at the beginning of 2013. “We are thrilled with the participation and look forward to incremental increases in the near future. This participation further validates our solid plan design,” said Peterson. “We wanted to have the most robust plan design possible to motivate employee participation and provide real financial value. So far, our employees have embraced the new design, as evidenced by the uptick in participation.”

One of the keys to Hologic’s successful rollout of its revamped ESPP was a comprehensive communications plan. Hologic first identified key milestones and the best ways to communicate the ESPP changes to employees. Using a combination of printed materials, emails, posters, webinars, and seminars, it was virtually impossible for employees to escape news of the ESPP changes.

The ambitious communications campaign focused on a message of “opportunity.” All elements reinforced the message that this was an opportunity for additional savings and an opportunity to become aligned with the long-term growth of the company. The opportunity continues to appeal to employees as seen by the increased participation in the second offering.

Hologic’s ESPP:
- 15% discount, six-month look-back
- 36% of Fidelity ESPP clients have this type of plan
ESPPs provide an opportunity for employees to align their financial interests with the long-term growth of the company. To determine whether employees were viewing their ESPP as a long-term investment, Hologic measured how many employees sold shares immediately after purchase.

“We knew that some employees merely saw the ESPP as a method to earn a 15% rate of return on a short-term investment, and chose to sell shares immediately after purchase—typically within a week,” said Peterson. “But we were pleasantly surprised to see that these employees were in the minority, as about 80% of the shares purchased by employees were not sold immediately after the purchase.”

Peterson suggests that, when making changes to an existing ESPP, companies should be mindful of how any changes may affect company expenses and its ability to hit earnings-per-share targets. It’s also important to consider whether the company’s systems can handle the operational requirements for any changes. Finally, he recommends communicating news of the changes broadly using a variety of methods.

“By and large, employees gave positive feedback on how we presented the information, the informational tools we provided, and the enrollment system,” said Peterson. “Overall, the process went very smoothly and we were quite pleased with the results.”
Case Study

Starbucks Finds Safe Harbor ESPP Fits Just Right

Starbucks Coffee Company believes that participation in the ownership of the company benefits both employees ("partners") and the company, and the Starbucks ESPP supports this tenet. The Seattle-based company has won wide recognition for its equity compensation plans over the past several years. This includes its broad-based equity compensation plan (Bean Stock) and ESPP (S.I.P. Stock Investment Plan).

Since 2009, the Starbucks S.I.P. has been a “safe harbor” plan (one that did not require accrual of compensation expense on the company’s financial statements). The plan is qualified under Section 423 of the Internal Revenue Code and provides for the purchase of stock at 95% of the fair market value on the date of purchase, with no look-back. Previously, Starbucks offered a 15% discount and a six-month look-back.

In 2009, the company conducted a comprehensive review of its benefits programs, and decided to enhance the 401(k) plan and the broad-based Bean Stock plan. With the increased expense of the Bean Stock plan, the ESPP was converted to a safe harbor plan to avoid additional compensation expenses. Without option-like features, and the discount set at 5%, there is no compensation expense associated with the plan under accounting rules.

Although participation rates in the ESPP declined by 25% after these changes took effect, the company has seen a slow but steady rise since then. Currently more than 13,000 partners, or nearly 12% of the eligible population, participate in the S.I.P.

“"If a partner is hired after May 1 of our fiscal year, they have to wait until the following year to participate in Bean Stock," says Billy Vitense, Director of Stock at Starbucks. “But with the S.I.P., partners can participate after only 90 days. This provides a great way for them to feel connected to the business and participate in the ownership culture we have created at Starbucks. This mindset carries over to the day-to-day operations, as partners are always looking for innovative ways to be more efficient and productive."

Purchases in the S.I.P. occur on a quarterly basis, and partners can contribute up to 10% of their base pay. To be eligible to participate, partners in the U.S. or Canada must be paid an average of 20 hours per week during the three months preceding the quarterly offering period.

To make the most of the S.I.P., Starbucks takes a multipronged approach to communications and education. To create awareness, the company uses “Lunch and Learn” sessions, podcasts, District Round Tables, and even Facebook advertising. Partner testimonials help to make the message more real, and online tutorials are available. Starbucks focuses on delivering the right information at the right time, while being careful not to overwhelm partners with too much information.

Starbucks’ ESPP supports the company’s philosophy of promoting broad-based stock ownership among partners, while allowing the company to keep compensation expenses low.
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